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SMEs' Demand for Trade Finance in Africa: the Case of Kenya and Tanzania

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KEY MESSAGES

- **SMEs are more self-rationed in the trade finance market than are large firms. Close to 20% of SMEs did not apply for trade finance even though they needed it, compared with 4% of large firms.**
- **Over a quarter of SMEs have no alternative form of finance or are forced to use working capital following rejection of their trade finance applications.**
- **About one in six SME exporters fail to meet some export sales because of a lack of access to trade finance.**
- **The average value of trade lost for an SME in Kenya and Tanzania due to the lack of access to trade finance is estimated at USD 49,672 annually.**

1 | INTRODUCTION

The trade finance gap in Africa has been widely researched over the years and remains unacceptably high, at USD 81.8 billion in 2019 (AfDB-Afreximbank, 2020). The COVID-19 pandemic, which further disrupted trade in Africa, also affected the trade finance activities of banks across the continent, according to a survey on the impact of COVID-19 on African Trade Finance (Afreximbank et al., 2020). Small and medium-sized enterprises (SMEs), which are among the most significant contributors to African economies, were particularly affected by limitations in the supply of trade finance (Afreximbank et al., 2020).

The trade finance landscape for SMEs in Africa has typically been viewed from the perspective of banks. Previous analyses by the African Development Bank (AfDB) based on multiple surveys of over 600 banks in 49 countries between 2012 and 2019 have reduced the knowledge gap on trade finance supply in Africa. However, much is left. The most recent trade finance survey conducted by the AfDB in 2021 focuses for the first time on African firms.

With a spotlight on Kenya and Tanzania, this policy brief reveals that close to a fifth of the SMEs surveyed are discouraged from applying for trade finance compared to 4 percent of large firms. More than half of the SMEs who didn't apply for finance cite the fear of default and rejection of their trade finance application as the primary reasons for not applying. SMEs also report high trade finance application rejection rates with over a quarter having no alternative form of finance or forced to use other

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more expensive working capital solutions. The lack of access to trade finance resulted in one in six SME exporters failing to meet some export sales. The estimated value of trade lost averaged USD 49,672 a year per firm in Kenya and Tanzania.

1.1. OVERVIEW OF SMES' DEMAND FOR TRADE FINANCE

Demand for trade finance among SMEs in Kenya and Tanzania overall is significant. The AfDB survey indicated that about 68 percent of SMEs needed trade finance, relative to 56 percent of large firms (see Figure 1). Moreover, 18 percent of SMEs that needed trade finance did not apply for it. This is much higher than the 4 percent of large firms that made the same decision (see Figure 1). While large firms that chose not to apply for trade finance cited heavy bureaucracy and time-consuming processes as their main reasons, the majority of SMEs did so out of fear of default and rejection of their requests. Reto and Dietrich (2021) find that 60 percent of discouraged Swiss SMEs would have obtained a bank loan if they had applied. Thus, not applying for much-needed trade finance due to fear reflects missed opportunities in trade participation for SMEs in Kenya and Tanzania.

1.2. TRADE FINANCE INSTRUMENTS USED BY SMES

From the AfDB survey data, it is noted that short-term revolving credit, pre-export finance/import loans, and letters of credit are the main instruments used by both SMEs and large corporates. However, SME exporters rely more on pre-export finance and supply chain finance than do large exporters. On the other hand, SME importers use short-term revolving credit and import loans more often than large importers (see Figure 2). Also, 60 percent of trade finance assets of African banks are unfunded transactions, such as letters of credit and documentary collections (AfDB-Afreximbank, 2020).

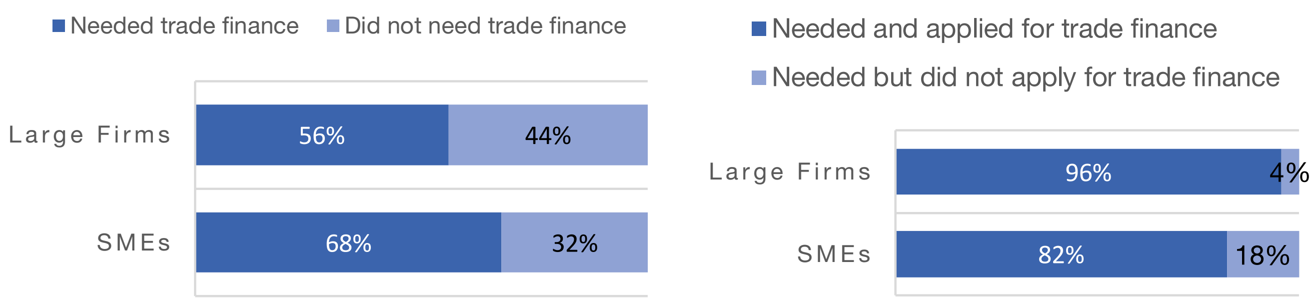
Given the predominant use of funded instruments by African firms, instruments that are relatively new in Africa but widely used elsewhere, such as factoring and supply chain financing, should be adapted to the local context to increase their use by both SMEs and large corporates. Additionally, SMEs could benefit from capacity-building programs sponsored by multilateral development banks or other organizations to increase their usage of more sophisticated trade finance instruments such as letters of credit and credit insurance that tend to be less risky and less costly.

2 | SME ACCESS TO TRADE FINANCE IN KENYA AND TANZANIA

SMEs have low access to trade finance services in Africa and make up only about 34 percent of banks' trade finance facilities (Amoussou et al., 2021). Banks' high rejection rate of SME trade finance applications is well documented. Over half of global trade finance requests by SMEs are rejected, compared with just 7% for multinational companies (WTO, 2016). In Africa, banks rejected about 40 percent of the trade finance facility applications received from SMEs in 2019 (AfDB-Afreximbank, 2020). In Kenya and Tanzania, while banks reported SME letter of credit (L/C) application rejection rates of 3 percent and 35 percent respectively, SMEs put these figures at 22 percent and 17 percent (see Figures 3 and 4).

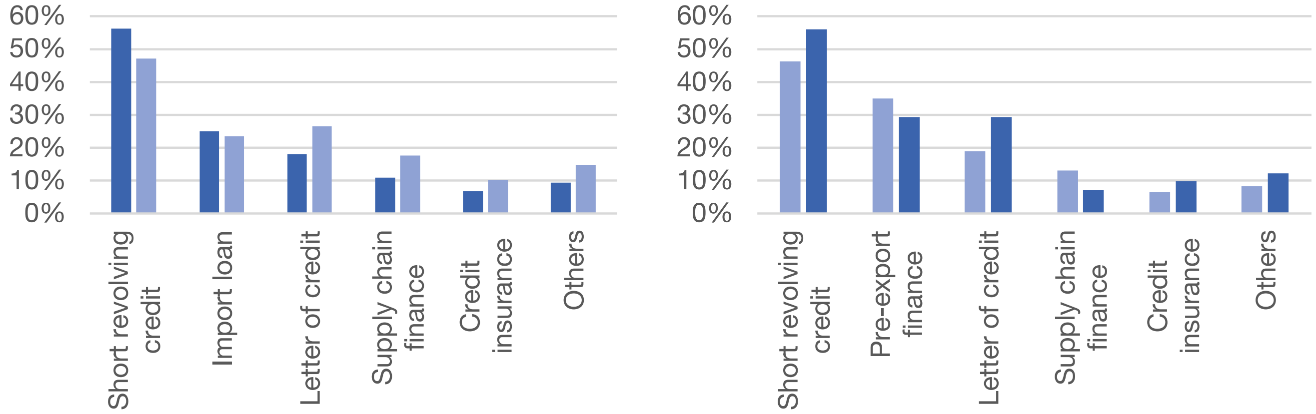
In both countries, SMEs and banks do not appear to be aligned in the rejection rates reported, reflecting the broader misalignment in the supply and demand of trade finance for SMEs. No large firm in Tanzania that applied for trade finance was rejected. Only 14 percent of large Kenyan firms had their trade finance applications rejected (compared with 22 percent of Kenyan SMEs). All firms listed insufficient collateral as the primary reason for the rejection of their trade finance applications. This is consistent with one of the primary reasons cited by banks for rejecting firms' applications (AfDB-Afreximbank, 2020). Guarantee instruments that directly cover the default risk of SMEs, such as first-loss partial guarantees, could be offered by development finance institutions (DFIs) or other interested parties to help address the challenge of insufficient collateral.

FIGURE 1 TRADE FINANCE NEEDS BY FIRM SIZE



SOURCE Authors' calculations based on AfDB 2022 Trade Finance Survey data.

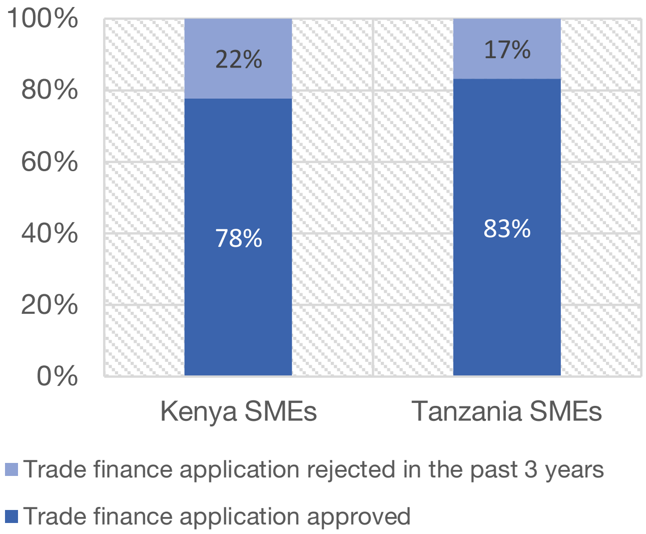
FIGURE 2 TRADE FINANCE INSTRUMENT USAGE BY FIRM SIZE



SOURCE Authors' calculations based on AfDB 2022 Trade Finance Survey data.

Following rejection by banks, over a quarter of SMEs had no alternative form of finance or were forced to use other non-bank working capital solutions, while large firms did not resort to such measures (see Figure 4). Most large firms reported getting alternative finance from banks, while the others made upfront payments.

FIGURE 3 SME TRADE FINANCE APPLICATION REJECTION RATES REPORTED BY SMES



SOURCE Authors' calculations based on AfDB 2022 Trade Finance Survey data.

3 | IMPACT OF LACK OF ACCESS TO TRADE FINANCE ON SMES

3.1 LACK OF ACCESS TO FINANCE AND TRADE PARTICIPATION

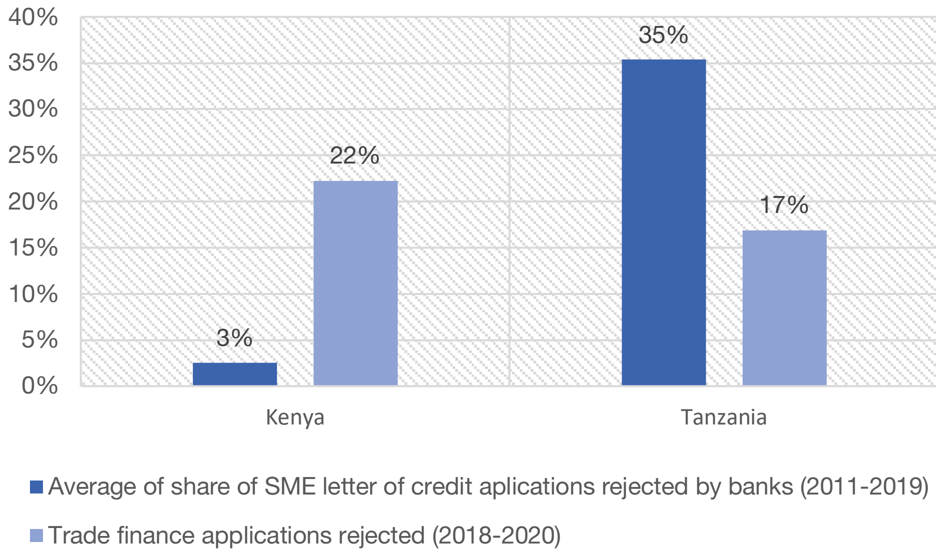
Lack of access to trade finance undoubtedly impacts firms' international activities. For example, over 20 percent of exporters in Kenya and Tanzania reported failing to meet export sales due to the lack of access to finance (AfDB, 2022). SMEs also reported negative impacts on their activities because of the lack of access to trade finance (see Figure 5). On average, SME exporters stated that they failed to meet export sales in higher proportions than SME importers. This is observed when all firms are also considered (AfDB, 2022). Indeed, Amiti and Weinstein (2011) find that banks' limiting trade finance is more likely to affect exports than domestic sales.

The reported impact on large firms as opposed to SMEs differs by country. In Kenya, fewer SME exporters indicated that the lack of access to trade finance has an impact on their export sales compared with large exporters, while the reverse is true in Tanzania. Large firms exporting in Tanzania did not report any negative impact on their export activities from lack of access to finance. A similar inverse relationship is observed for SME importers versus large importers in Kenya and Tanzania. Kenyan SME importers report failing to meet import purchases more often than large Kenyan importers, while fewer Tanzania SME importers report the same relative to their larger counterparts. The underlying reasons for this are subject to further research.

3.2 LACK OF ACCESS TO TRADE FINANCE AND THE VALUE OF TRADE FORGONE

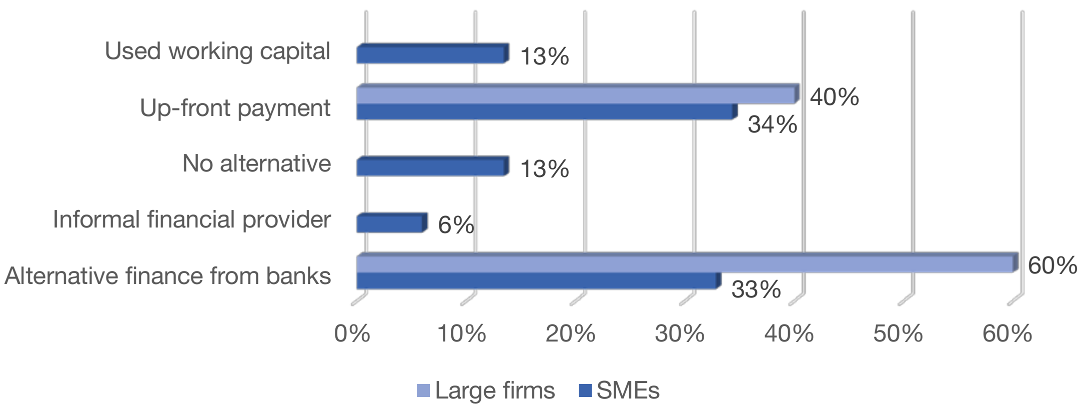
Access to trade finance is critical for SMEs as they seek to expand their operations either domestically or through international trade. Estimating the value of trade forgone due to SMEs' lack of access to trade finance provides some context on how vital trade financing is for these firms. Between 2018 and 2020, the average SME lost about USD 223,135 in Kenya and USD 75,000 in Tanzania due to the inability to obtain trade finance (see Figure 6). This translates to approximately USD 74,378 and USD 24,966 of trade value lost annually by SMEs in Kenya and Tanzania, respectively.

FIGURE 4 SME TRADE FINANCE APPLICATION REJECTION RATES REPORTED BY BANKS



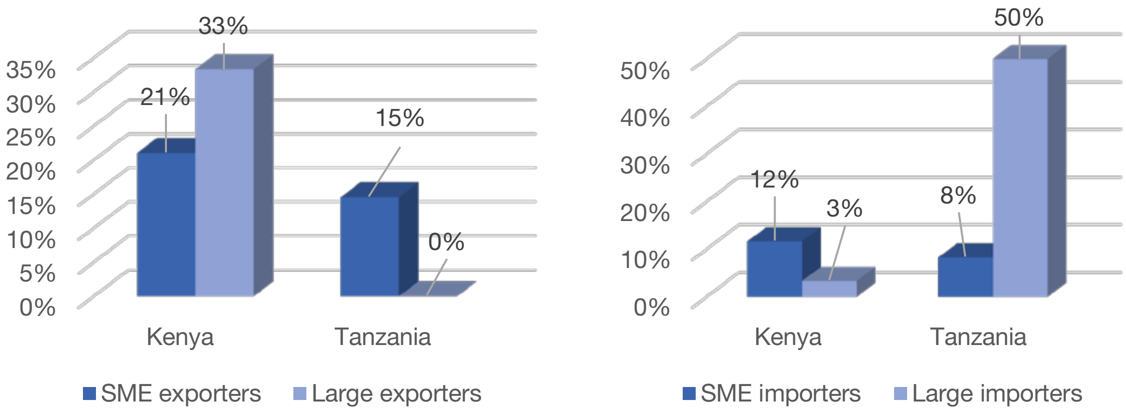
SOURCE Authors' calculations based on AfDB 2022 Trade Finance Survey data.

FIGURE 5 ALTERNATIVE TO TRADE FINANCE FOR SMES WITH REJECTED APPLICATIONS



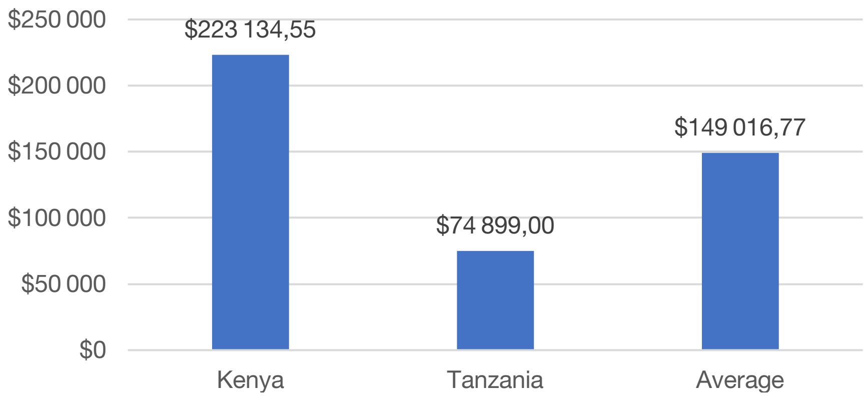
SOURCE Authors' calculations based on AfDB 2022 Trade Finance Survey data.

FIGURE 6 IMPACT OF LACK OF ACCESS TO TRADE FINANCE ON TRADE ACTIVITIES BY FIRM SIZE



SOURCE Authors' calculations based on AfDB 2022 Trade Finance Survey data

FIGURE 7 AVERAGE VALUE OF FORGONE TRADE FOR SMES OVER THE PAST THREE YEARS



SOURCE Authors' calculations based on AfDB 2022 Trade Finance Survey data.

4 | CONCLUSION AND RECOMMENDATIONS

SMEs in Africa need trade finance, and more insights can be obtained by assessing their needs based on information obtained directly from them as opposed to via banks. The AfDB has, for the first time, conducted a survey of Kenyan and Tanzanian firms in the trade finance space. The survey data show that over half of the SMEs reported needing trade finance, with a nontrivial share (18 percent) choosing not to apply for trade finance due to the fear of default and rejection. Furthermore, rejection rates for SMEs' trade finance applications are high from both the perspective of both banks and SMEs. Banks appear to underestimate the rejection rates of SMEs in Kenya while overestimating the rates in Tanzania relative to what SMEs reported. The primary reasons for rejections — insufficient collateral — is consistent across firms by size though more SMEs report not having alternative sources of finance after being rejected compared to large firms. The effect of rejecting SMEs' trade finance applications is also noteworthy. Over one in five SME exporters in Kenya and Tanzania fail to meet some export sales due to a lack of access to trade finance. The value of trade lost due to unmet trade finance demand for SMEs is estimated at approximately USD 74,378 and USD 24,966 a year in Kenya and Tanzania, respectively.

Measures should be adopted to boost support for SMEs' access to trade finance by addressing the key challenges they face; this will require a collaborative effort from all stakeholders. For example, capacity-building programs sponsored by DFIs or other organizations could enhance the trade finance product knowledge of SMEs and enable them take advantage of more sophisticated trade finance instruments offered by commercial banks. Efforts to completely digitalize trade finance could also help tackle some of the challenges faced by SMEs. First, adopting digital solutions to trade finance transactions could help reduce the time and monetary costs associated with document processing by banks and increase the supply of trade finance (Bempong Nyantakyi and Drammeh, 2020). It could also reduce delays in processing for firms, minimize bureaucracy, and drive down transaction costs (AfDB, 2022). Furthermore, using new technologies to set up shared know-your-customer registries and facilitate credit information sharing could reduce some information asymmetries plaguing SMEs. Governments could help facilitate SMEs' and financial institutions' embracing of digital technologies in trade finance with digital-friendly policies and initiatives.

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